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Accounting for Farmers and Ranchers

Sue Wegenhoft Briscoe

ACCOUNTING FOR FARMERS AND RANCHERS

The author discusses the substantial tax benefits available to farmers and ranchers who are knowledgeable of accounting procedures and tax rules and use them advantageously.

Sue Wegenhoft Briscoe, CPA
Eagle Lake, Texas

The farming and ranching industry is a gigantic one, which is most important to the social and economic structure of our modern civilization. Yet, there is probably less material written about farm and ranch accounting and related tax problems than for any other major field of business enterprise.

For the most part, accountants and those with the Internal Revenue Service know little about the physical operations of a farm or ranch, and farmers and ranchers know little about accounting records or tax regulations. Most farmers and ranchers have no office outside their homes and their records often consist of deposit slips, cancelled checks, notes made in a little black book, and little else.

In setting up records, a double entry system should be used with appropriate journals and a general ledger. The farmer and the rancher have the option of keeping their records and preparing their income tax returns on a cash receipts and disbursements basis or on an accrual basis.

Cash Basis

If a cash basis is adopted, taxable income is not recognized until actually received, and expenses are not deducted until actually paid.

When a rancher purchases an animal for draft, breeding or dairy purposes, he must capitalize the purchase price of the animal and depreciate this cost over the animal's productive life, with due regard to salvage value. Raised animals receive different treatment from those that are purchased. The cost of raising the animals can be deducted as a current expense of operations.

The cash method will defer income while building up a herd since no income is realized for tax purposes until the cattle are sold, and no tax need be paid on the inventory value of livestock or produce on hand at the end of the year.

Under the present estate tax laws, a herd of raised livestock can be inherited at the date of the decedent's death and no income taxes will be due on its increase in value. There will be an estate tax liability on the value of the herd, but no income tax will ever be paid on this increase in value. At the date of death, a herd of raised livestock, which had a zero basis because the cost of raising it had been deducted as a current operating expense, will take on a basis, in the hands of heirs, equal to its market value at date of death. Thus, it is possible to build up an estate and pay no income tax on profit arising from the growth of the animals.

In the case of breeding, dairy, or draft animals sold, only one-half of the net income is taxable as long-term capital gain if the animals have been held for at least 12 months.

In the cash method of accounting, the basis

SUE WEGENHOFT BRISCOE, CPA, spends about half of her time operating her own public accounting practice which she established 14 years ago in Eagle Lake, Texas after serving four years as County Auditor of Colorado County. A graduate of Baylor University with a major in accounting (B.B.A., 1947) and of the University of Texas with a major in law and accounting (M.B.A., 1950) she also worked for a public accounting firm in Houston in 1949 and 1950.

With her husband, Lee (also an accountant with a degree from the University of Texas), she has traveled extensively abroad during the past seven years, touching every continent and most of the free countries in the world. Home is Eagle Lake, Texas and they have a ranch at La Grange, Texas.

Mrs. Briscoe is a member of the American Institute of Certified Public Accountants, the Texas Society of Certified Public Accountants, the American Woman's Society of Certified Public Accountants, the American Society of Women Accountants and the Texas University Ex-Students Association. She has served ASWA as a national director, treasurer and first vice president and was listed in the first edition of Who's Who of American Women, the twelfth edition of World Who's Who in Commerce and Industry and in 1962 was listed in Texas Women of Distinction.

of the raised animal is zero, and the difference between this zero basis and the sales price is reported as the sale of a capital asset on which long-term capital gain is taken. In the case of the animal which is purchased, the basis is the cost less any depreciation taken up to the date of the sale.

With a large herd of cattle, where it is not known which animal was sold, the taxpayer should use the first-in, first-out method of determination. If it is not known whether the animal was purchased or raised, it is to the taxpayer's advantage taxwise to report the animal as being raised because he takes depreciation on the animals which he has purchased. This depreciation is charged against ordinary income and deducted 100% rather than 50% which is applicable to capital assets.

Certainly, if it can be determined whether the animal was purchased or raised, it should be reported accordingly. However, as a practical matter, very often a rancher does not know whether an animal was purchased or raised in a large cattle operation, so he should keep in mind the tax aspects of the transaction.

While the use of the cash receipts and disbursements method may result in distorted income from an accounting point of view, it has substantial tax benefits as pointed out in the above paragraphs.

Accrual Basis

The other method of accounting, based on accruals, will give a more accurate accounting of the business but it lacks some of the tax advantages of the cash receipts and disbursements method. In most cases it is probably better for the farmer and the rancher to use the cash method instead of the accrual method. Under accrual procedures, the taxpayer reports income as it is earned, whether or not received, and deducts expenses as they are incurred, even though actual payment has not been made.

On an accrual basis, the taxpayer computes his taxable income with the use of beginning and ending inventories, choosing one of the following four methods as a basis for costing:

Unit livestock price
Farm price
Cost
Cost or market, whichever is lower

The unit livestock price method is probably the most convenient for inventory use. It is recognized that operating conditions existing in the livestock industry are such that actual costs are impossible to secure. Therefore, prices which reflect reasonable estimates of normal costs of production are acceptable. The raised animals are classified into different age groups, and different amounts are assigned to these groups. A taxpayer who determines that it costs approximately $30.00 to produce a calf and $20.00 a year to raise the calf, could set up classifications such as:

Calves	$30.00
Yearlings	50.00
Mature animals	70.00

The unit livestock price method can be used only for livestock raised on the farm, and, if used, must be applied to all animals raised, regardless of whether they are for sale, breeding, draft, or dairy purposes. If the unit price method is used, any livestock purchased must be included in inventory at cost. The exceptions are animals purchased for breeding, dairy, or draft purposes, which may be treated as depreciable assets.

The other inventory method most widely used is the farm price method. Under this method, inventories at the beginning and end of the year are valued at the market price, less selling expenses and cost of transportation. Under this method the taxpayer may pay an income tax on the value of livestock which may never be realized if the market price goes down before actual sales are made.

The inventory methods of cost, or cost or market, whichever is lower, are seldom used by ranchers because it is difficult to allocate cost in a livestock operation.

If raised breeding stock is inventoried, the increase in inventory value each year is taken up in the tax return as ordinary income until the animal is grown. The accrual basis has the advantage of preventing income from being pyramided in certain years. The accrual method can generate income in the early years which will offset the high expenses of herd building. This will reduce taxable income when sales are made from the herd in later years.

Once the choice of an accounting method is made, the taxpayer is bound by his choice unless the Internal Revenue Service consents to a change. I have found that it is almost impossible to obtain permission to change from the accrual method to the cash method. Thus, I would advise starting with the cash method.

Income Averaging

If the taxpayer is on the cash basis and finds that through circumstances beyond his control he has income pyramided in one year, he can get some relief from tax at a higher rate by averaging his income. Taxpayers having unusual fluctuations in income have been provided with an averaging device to ease the tax bite in peak income years. The formula for averaging income is complicated, but if the taxpayer will use Schedule G (Form 1040) to average his income he will achieve the tax savings available to him through the means of income averaging.

Cost Allocation

If a taxpayer is planning to buy a farm or a ranch, he should try to arrange the terms of the purchase contract to his best tax advantage. For example, allocate as much of the purchase price as possible to particular assets in order to obtain a higher cost basis for them. This will reduce taxable income from assets which are to be sold, such as cattle, crops, and so forth. Or, it could increase depreciation deductions from depreciable property acquired, such as barns, fences, cribs, tractors, and other pieces of farm machinery.

On inherited farm or ranch property, it isn't always advisable to value it at the lowest possible figure in order to hold down the estate tax. A higher valuation may ultimately save more in income taxes than the immediate increase in estate taxes.

Investment Credit

If a taxpayer buys or builds farm machinery, vehicles or other property used in farming or ranching business, he should check to see whether it qualifies for the investment credit. If it does, it can generally reduce the income tax liability by 7% of the cost of property qualifying for credit in the first year of use of the property.

The credit is generally limited to investment in tangible, personal property (other than livestock) and certain real property (other than buildings and their structural components). Fences used in connection with raising livestock can qualify.

Conservation Expenditures

A farmer may deduct soil and water conservation expenditures which do not give rise to a deduction for depreciation and which would increase the basis of the property except where he elects to deduct them. The expenditures must relate to land used in farming by the taxpayer or his tenant at the time the expenditures are made or at some time prior thereto.

The deduction is limited annually to 25% of the taxpayer's gross income from farming. The excess is deductible in succeeding taxable years without time limitation, but in each year the total deduction is limited to 25% of the gross income from farming in the year of the deduction.

Deductible expenses include the cost of leveling, grading, terracing, contour furrowing, construction, control and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets and ponds, the eradication of brush, the planting of windbreaks, and other treatment or moving of earth.

A farmer may elect to treat as deductible expenses, rather than as capital charges, expenditures for clearing land if such expenditures are for the purpose of making the land suitable for use in farming. The deduction is limited in any taxable year to $5,000.00 or 25% of the taxable income derived from farming during the taxable year, whichever is less.

Involuntary Conversion

If a taxpayer received payments for livestock sold or destroyed because of disease or drought, any gain can qualify as gain from an involuntary conversion. The taxpayer can elect to defer the tax if the animals are replaced.

Operating Losses

Losses incurred in the operation of farms or ranches as a business are deductible in the same manner as any net loss from a trade or business, including carry-over and carry-back of the net operating loss. Thus, if the farmer operates a farm in addition to being engaged in another trade or business and sustains a loss from such farm operations, the amount of loss sustained may be deducted from gross income received from all sources, provided the farm or ranch is not operated for pleasure.

The question of the taxpayer's intention to operate for profit or pleasure is a matter to be determined in every case from the facts and circumstances. Ordinarily, the fact that the farm or ranch has not been operated at a profit for many years is not enough to warrant the disallowance of farm expenses, even though it is shown that the owner is pursuing other business interests.

A special tax rule limits the loss deduction of farms which have losses in excess of $50,000.00 for five consecutive years. In determining whether deductions from the farm or ranch have exceeded gross income by $50,000.00 or more over a period of five consecutive years, each spouse in a community property state is considered as a separate taxpayer.

Tax Planning

It is very important that farmers and ranchers do tax planning. Before large sales are made, it is important to consider the overall tax consequences. If a farmer or rancher has children who work for him on the farm or ranch, paying them a reasonable wage for their work will reduce the farmer's or rancher's taxes. He can deduct his children's pay for work performed to the same extent as other farm wages, and may still be able to claim them as dependents.

Estate Planning

It is very important that farmers and ranchers do some estate planning. Under the present practice of the Internal Revenue Service, land is valued at current market price or the amount similar land is selling for on the current market. The farmer or rancher should give some thought to making gifts of some of his property to his children. The farmer or rancher might also give some thought to the advantages of taking his children into his business and forming a partnership.

Trusts are another effective avenue to achieve desired estate planning ends for a farmer or rancher.

In Conclusion

To summarize, the farmer or rancher will benefit economically from a good understanding of accounting procedures and tax regulations. Usually, a cash basis of accounting will be to his advantage and an informed application of the proper tax rules will enable him to conserve more of his hard-earned dollars for himself and his family.

PHILOSOPHY OF ACCOUNTING (3)

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A final example. An expert verifies the depreciation of two identical machines, bought the same year. He examines the purchase invoice, the computation of depreciation, and is satisfied with their value as accounting documents. He makes a report that he declares to be true and exact. It appears, however, that his report is false. One of the two machines is no longer in existence because it has been destroyed in an accident. The insurance company had paid an indemnity but this was not recorded. A new machine had been purchased to replace it and the depreciation continued on the former machine.

Even if the accountant had taken the trouble to look at the machines, he would not have noticed anything except that the destroyed machine was at rest. But—our reports are always true—and exact.

TWENTY-FIVE YEARS AGO—in THE WOMAN CPA

The first mathematicians were the priests who calculated the advent of the seasons. History tells us that the early Egyptian temples were equipped with instruments to note the rise and fall of the Nile. But the great mass did not see any connection between prophecy and reality. Reading and writing were mysteries for centuries but the twentieth century made them common knowledge—at least in this country. Today the ordinary man knows something about scientific discoveries even though he doesn't know their mathematical bases. Side by side with the development of modern art and modern industry has been the development of commerce and finance. And most persons have some knowledge of them just as their primitive ancestors observed the rise and fall of the river but all they know about the mathematical side is that commerce and industry are represented by figures so astronomical that they are not to be understood.

From "Mathematics In Its Relation To The Commercial World"

by Jane E. Goode, CPA, October, 1943